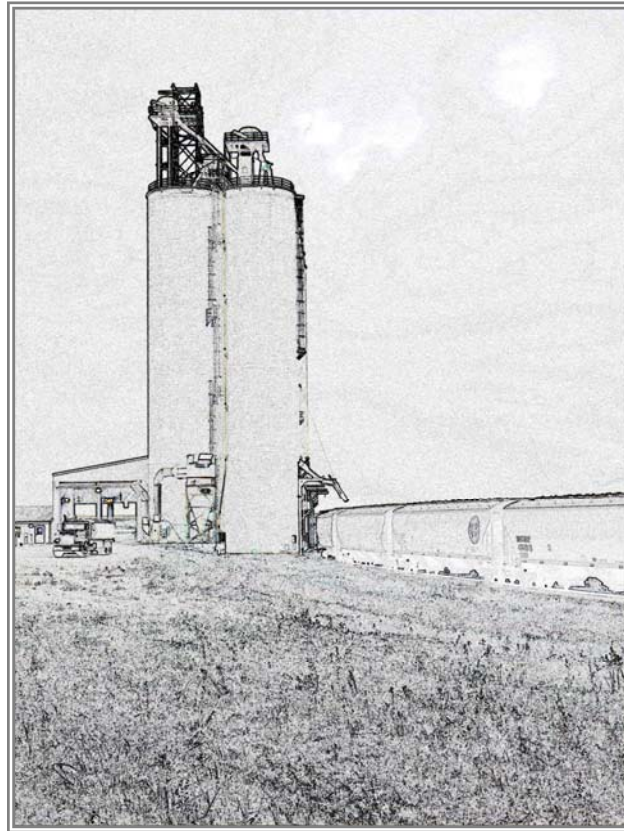


# Montana Rail Overview



October 28, 2005

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*Montana's economy is primarily resource based. Rail freight transportation is considered to be a major segment of the infrastructure supporting the state's economy. The vast majority of Montana's production and extractive industries are weight intensive, move in large volumes, and are transported considerable distances. As a result, rail transportation is frequently the most economical or feasible transport mode for shippers. This is true of agricultural products, coal, woodchips and ores. The spatial economy of the state is dependent on rail services.*      *1978 Montana Rail Plan*

### **Introduction**

As noted in the above excerpt from the 1978 Montana Rail Plan, Montana's rail system was, and still is, critically important to Montana's economy.

This report includes a review of the most significant economic and regulatory events and conditions that led to Montana's current rail system and a review of potential solutions to Montana's current reliance on a single Class I railroad. In addition, the report includes a summary of issues related to the Havre to Big Sandy and Plentywood to Scobey Branch Lines that are potential targets for abandonment.

Contributors to this report included the Governor's Office of Economic Opportunity and the Montana Departments of Agriculture, Commerce, and Transportation. The report also relied heavily on analysis, text, and data from the 2004 *Senate Bill 315 Rail Freight Competition Study*, which was requested by the 2003 Legislature and sponsored by Senator Trudi Schmidt of Great Falls. The advisory committee for the study included business executives, economic development experts, representatives from rail customer groups, and legislators.

## **Rail System Overview<sup>1</sup>**

Montana Railroad Route Miles in 2005: 3,236

Montana Railroad Route Miles in 1982: 5,126

Percent of Montana Railroad Mileage Owned by BNSF: 94.2%

Montana Rank Nationally in Percent of Rail System Owned by One Class I Railroad: 1

### **Montana 2002 Carload Statistics**

Originated: 346,858

Terminated: 55,617

Bridged: 1,201,190

<b><u>2002 Rail Carrier Traffic Shares</u></b>			
	<b>Tons</b>	<b>% Total</b>	<b>Revenue</b>
BNSF	38,340,669	91.0%	\$670,010,499
MRL	3,124,616	7.4%	\$25,015,632
UP	416,336	1.0%	\$24,726,992
CPRS	252,477	0.6%	\$12,185,762

Impacts of Lack of Rail Competition to Montana:

- Costs of moving export wheat by rail to Pacific Northwest ports are 50% higher than those in states with transportation alternatives.
- Increased costs to Montana producers total \$60 million per year
- Impact of increased grain transportation costs to value of Montana farmland: \$1 Billion

Major factors affecting Montana businesses that rely on railroads:

- Limited rail competition
- Relatively small transportation market especially for inbound movements
- Montana's geographic position and distance from more robust markets on the West Coast and in the Midwest
- Staggers Rail Act emphasis on financial health of the railroads, and the interpretation of Staggers by the Interstate Commerce Commission (ICC) and Surface Transportation Board (STB)
- Limited bulk commodity transportation options other than rail
- Class I railroads are operating at or near capacity

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<sup>1</sup> *Senate Bill 315 Rail Freight Competition Study*, prepared by RL Banks & Associates for the Governor's Office of Economic Opportunity, 2004

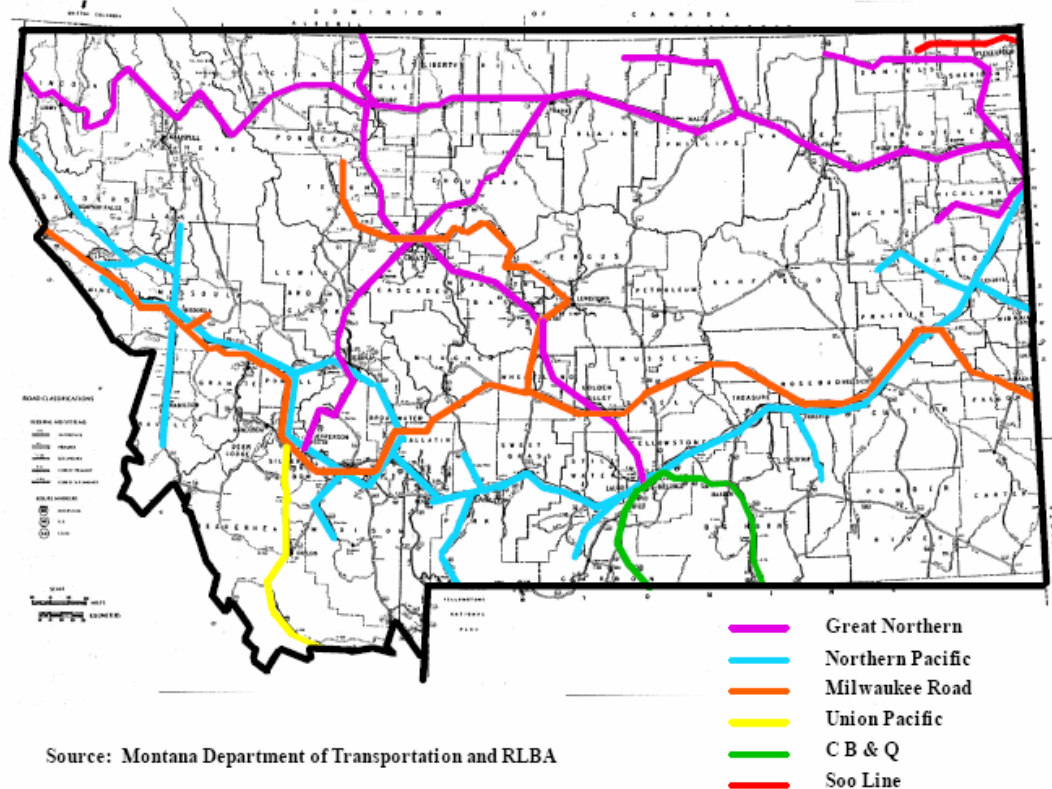
## Background

Montana's dependence on just one major railroad is the result of a combination of events and factors including railroad mergers and consolidations, Federal regulatory changes, infrastructure changes, and geography.

### Mergers and Consolidations

As shown in Map 1, prior to 1970 – when Great Northern Railway (GN), Northern Pacific Railway (NP), Chicago, Burlington & Quincy Railroad Company (CBQ) and Spokane, Portland & Seattle Railway System (SPS) merged to form Burlington Northern Railroad (BN) – Montana was served by the mainlines of six Class I rail carriers<sup>2</sup>. In addition to three of the aforementioned railroads, the Union Pacific Railroad (UP), Chicago, Milwaukee, St. Paul and Pacific Railroad (“Milwaukee Road” or MILW) and Soo Line Railroad also served Montana.

Map 1  
Montana Rail System Prior to 1970



With the exception of Union Pacific Railroad's mainline connecting Butte and Idaho Falls, these former Class I railroads (the "Hill lines") were the principal rail traffic

<sup>2</sup> Class I railroads are North America's largest railroads. The Surface Transportation Board designation defines a Class I railroad as one with operating revenues of \$272 million or more. This threshold is adjusted annually for inflation.

arteries connecting Pacific Northwest cities with major Twin Cities and Chicago gateways. While the majority of those mainlines still exist, most are now owned and operated by BNSF Railway (BNSF), itself the product of the 1995 merger of The Atchison, Topeka & Santa Fe Railway and Burlington Northern Railroad (Burlington Northern, or BN). Montana Rail Link, Inc. (MRL) operates, under lease, the BNSF mainline across southern Montana between Huntley, Montana, and Sandpoint, Idaho. The MILW mainline is abandoned. Attachment 1 shows Montana's pre-1970 rail system compared with today's rail system.

### *Creation of Burlington Northern Railroad*

Beginning in 1970, the merger which resulted in BN brought four formerly independent Class I railroads into a single entity, which reduced from six to four the number of Class I railroads serving the State. More particularly, Montana's two principal east-west mainline corridors, the former GN "Hi-Line" across northern Montana and the former Northern Pacific across southern Montana, were both properties of merger applicants, subsequently consolidated. MILW was the only other east-west operator offering a competitive alternative to BN, and it was in a financially precarious condition.

James J. Hill made several unsuccessful attempts over the years to merge his NP and GN, as well as the CBQ, also controlled by NP and GN. After the Interstate Commerce Commission (ICC) again denied a merger petition in 1966, the Northern Lines promised to address concerns of those opposing the merger, which included competition and labor protection.<sup>3</sup> Concessions offered to labor and competing railroads helped win over the ICC. Perceptions had also changed to emphasize that railroads were fighting not only to prosper but to survive. That shift in attitude caused ICC regulators to reconsider the BN merger in a broader context, concluding that "there would be 'no lessening of competition' at 92 percent of the freight stations, and shippers would enjoy faster and more dependable single-line service while further benefiting from the carriers' lower transportation costs."<sup>4</sup> After an unsuccessful challenge to the US Supreme Court, Burlington Northern was officially created March 2, 1970.

### *Milwaukee Road Collapse*

Another blow to Montana's competitive rail environment came on December 19, 1977 when the Milwaukee Road filed for bankruptcy protection. MILW's financial collapse was due in part to the fact that, as the last transcontinental rail carrier built, it could neither select the best route profile, nor take advantage of extensive land-grant opportunities bestowed upon Northern Pacific.<sup>5</sup>

State, shipper, and employee efforts to preserve large portions of the MILW were unsuccessful. Montana initially supported the "New Milwaukee Lines" (NewMil), a non-

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<sup>3</sup> Frank N. Wilner. *Railroad Mergers: History, Analysis, Insight*, 1997, pages 171-174.

<sup>4</sup> Wilner, Page 175

<sup>5</sup> *State Rail Plan*, August 1979, Montana Department of Highways (Montana Rail Plan 1979), page 54.

profit corporation composed of shipper and employees' interests.<sup>6</sup> The ICC rejected the NewMil plan on December 31, 1979 because it lacked adequate financing. The MILW Bankruptcy Trustee then began negotiations with other railroads interested in purchasing portions of Milwaukee trackage. In January 1980, tentative agreement was reached with the Trustee that Montana would acquire the Milwaukee properties between Miles City and Washington for \$55 million, and Montana withdrew its support of NewMil.

In March 1980, the Trustee withdrew his sales offer to Montana and announced an agreement selling selected segments to BN. Although the Reorganization Court approved the agreement, Montana charged that it was not in the public interest, primarily because of loss of competitive rail services. In May, Montana filed its application to acquire and operate the Milwaukee Road lines between Miles City and Marengo, Washington, in order to retain competitive rail service and serve the public interest. The competition issue was "considered to be particularly important"<sup>7</sup> by Montana and the ICC accepted Montana's application for consideration concurrently with the BN application. Unfortunately, Montana did not have the fiscal resources to acquire the MILW lines and in August 1980 the ICC approved sale of certain Milwaukee Road properties to BN and Union Pacific. The ICC noted that there were deficiencies in Montana's application, including lack of funding, lack of an operator and the unwillingness of other railroads to grant necessary trackage rights to Montana. After casting off everything west of Miles City, Montana, MILW limped along in the 1980s until its remaining lines were purchased by the Canadian Pacific-owned Soo Line in February 1985.<sup>8</sup>

### Montana Rail Link

In 1987, Montana Rail Link (MRL) assumed control of the western portion of the BN mainline across southern Montana. MRL is a bridge carrier shuttling freight between its connection with BNSF at Huntley, Montana, and its connections with BNSF at Sandpoint, Idaho and Spokane, Washington. Although MRL is a new railroad in Montana, it is important to understand that (1) BNSF owns the mainline over which MRL operates, (2) MRL must obtain permission from BNSF to perform interchange with any other railroad, (3) MRL origins are treated as BNSF origins in the latter's tariff books, and (4) BNSF has agreed to provide to MRL a certain level of bridge traffic, on which the smaller carrier's financial performance depends. Thus MRL does not provide Montana a genuine competitive option.

### Federal Regulatory Changes

In addition to the specific railroad-related circumstances that began to reduce the number of carriers and the competitive thrust of their Montana operations, there were two Federal regulatory changes, beginning in the 1970s and continuing into the 1980s that exacerbated railroad problems facing the State of Montana.

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<sup>6</sup> *Montana Rail Plan Supplement* 1980

<sup>7</sup> *Montana Rail Plan Supplement* 1980, page 10

<sup>8</sup> Wilner, *op. cit.*, page 212.

### Railroad Revitalization and Regulatory Reform Act (4R Act) of 1976

In addition to creating Conrail, the 4R Act encouraged railroad consolidations, revamped abandonment procedures, and limited the amount of ICC merger proceeding deliberations, all of which were efforts to salvage the failing United States rail system.<sup>9</sup>

### Staggers Rail Act of 1980

Staggers, which was considerably more potent than the 4R Act, gave railroads the flexibility to set and publish rates and to negotiate confidential contracts with shippers with regard to services and rates. Furthermore, the ICC was directed to process abandonment requests more rapidly. These provisions were intended to improve the efficiency of railroads and facilitate their decision-making.

Staggers also permitted differential pricing, that is, pricing responsive to competitive conditions, as opposed to pricing according to cost of service. Staggers also allowed the railroads to pay relatively less attention to their common carrier obligation, with the result that railroad service now varies widely among customers.

It is generally acknowledged that Staggers brought about a major turnaround in the financial condition of the railroad industry. Released from burdensome restrictions and free to set rates, the financial performance of the railroad industry has substantially improved in the Staggers environment. Measuring Staggers against its stated purpose, the Act has been a success. Railroads have become more productive and more competitive and today enjoy considerably improved financial health. Also, railroad customers have gained in lower rail rates and improved service, in general. An estimated 60 percent of all U.S. rail traffic moves under contract as opposed to common carrier tariffs, or posted rates,<sup>9</sup> and contract rates are lower than posted rates.

On the other hand, *not all railroad customers have benefited equally*. As noted in a 2000 U.S. Department of Agriculture report, “Differential pricing allows railroads to extract higher prices from those shippers who cannot effectively use other modes of transportation.”<sup>10</sup> This means that “captive shippers” – those without competitive transportation options – pay higher rates than do customers with competitive options.

Montana, North Dakota, and a number of “captive” railroad customers within other states are not satisfied because of absence of railroad competition and competitive rates. Many railroad customers and their trade groups have expressed dissatisfaction with rates and rate relief procedures, describing the latter as burdensome, time-consuming and expensive. Dissatisfaction is especially acute among industries that are captive to one railroad and have no alternative to rail (for example, long distance shipments of bulk commodities, such as coal, grain or chemicals). Inasmuch as Staggers allows pricing based upon market value of service, or, “what the traffic will bear”, an equity issue is raised: “Why should Montana (or any other captive shipper) pay more for transportation

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<sup>9</sup> U.S. Congress, Subcommittee on Railroads, Hearing on the Status of Railroad Economic Regulation, “Background”, March 31, 2004, [www.house.gov/transportation/](http://www.house.gov/transportation/).

<sup>10</sup> Marvin Prater and Keith Klindworth, “*Long-Term Trends in Railroad Service and Capacity for U.S. Agriculture*”, U.S. Department of Agriculture, Agricultural Marketing Service, November 2000, page 9.



than other states?” Indeed, a further question is raised, since with its greater marketplace freedom a railroad is inclined to provide service to the shipper with a competitive option before it takes care of the captive shipper, “Why should Montana pay more for poorer service?”

Those who drafted Staggers were mindful of the possibility of market dominance and abusive rate setting, where competitive options are lacking, and they included provisions to provide relief where rates are deemed unreasonable.

With regard to rate reasonableness, Staggers limits regulatory jurisdiction to situations in which a rail carrier is deemed “market dominant” (49 U.S.C. 10701(d)). This is defined as a situation where there is an “absence of effective competition from other rail carriers or modes of transportation” (49 U.S.C. 10707(a)). Unless the Surface Transportation Board (STB) finds that market dominance exists, a rate challenge may not proceed.<sup>11</sup>

The STB does not have jurisdiction over rail rates that produce revenues less than 180 percent of variable cost; below this figure a railroad is presumed not to be market dominant (49 U.S.C. 10701(d)). (Variable costs are those parts of total cost that grow with output. They are defined as the sum of all costs that vary with output, for example, locomotive fuel and train crew wages.) Since railroads have high fixed costs that do not vary with service provided, for example, investment in track infrastructure; a rate of less than 180 percent of variable costs may not cover the full cost of providing transportation.

If the revenue-to-variable-cost percentage is over 180 percent and the STB is permitted to respond to a rate-reasonableness filing, it does so within the Staggers Act policy that all rail carriers should earn adequate revenues (49 U.S.C. 10701(d)(2)).

### McCarty Farms

McCarty Farms began in 1980 when a group of Montana farmers filed a class action in U.S. District Court alleging that Burlington Northern Railroad (BN) was charging unreasonable rates for transporting single cars of wheat. The following year an Administrative Law Judge found that BN was market dominant, was charging unreasonable rates (exceeding 200 percent of the variable cost of service) and that 200 percent should be the maximum reasonable rate.

In a separate proceeding, the State of Montana filed a challenge of the reasonableness of BN’s multiple-car rates for wheat and barley with the Interstate Commerce Commission (ICC). The ICC consolidated the two cases, but held them in abeyance. Following a complaint in district court, the ICC reopened the proceedings in 1984 and ruled that additional evidence concerning market dominance would be accepted. In 1987 the ICC ruled that BN was market dominant over wheat and barley shipments moving from Montana to the Pacific Northwest, and turned to the rate reasonableness analysis, deciding in 1988 that the revenue-to-variable cost standard was an appropriate means of testing rates and finding that the BN rates were unreasonable. The following year, the

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<sup>11</sup> U.S. Congress, Subcommittee of Railroads, *op. cit.*, March 31, 2004. Much of this discussion of Adjudication of Rate Disputes is drawn from this reference.

ICC issued an unpublished decision correcting several costing problems in the revenue-to-variable-cost test, recomputing the ratios by which reparations were to be calculated, and directing BN to submit a quantification of the reparations and a proposal to modify its rate structure. In 1991 the ICC affirmed its earlier decisions (BN market dominant, BN's rates unreasonable), calculated that BN owed over \$9 million plus interest in reparations, and imposed a future rate prescription procedure on BN.

BN filed a petition to clarify, asking the ICC to modify its calculations. The ICC voluntarily vacated its rate prescription order and then McCarty Farms, the State of Montana and BN sought review of the ICC decision by the U.S. Court of Appeals. In an opinion issued in 1993, the Court questioned the basis for the revenue-to-variable-cost test and remanded the proceedings to the ICC for reconsideration of whether it was appropriate to use the revenue-to-variable-cost test instead of the Constrained Market Pricing (CMP) test. The ICC directed McCarty Farms and the State of Montana to advise the Commission whether they wanted to proceed with the CMP test, await development of a suitable methodology, or pursue some other course of action. In April 1993 McCarty Farms notified the ICC of its election of the CMP test and the next month BN agreed with the use of CMP test.

Following the ICC Termination Act of 1995, the Surface Transportation Board (STB) ruled in August 1997 that McCarty Farms had failed to show under the CMP test that the rates were unreasonably high and discontinued the proceedings. McCarty Farms and the State of Montana filed a petition for review with the U.S. Court of Appeals. The STB agreed that there were errors in its 1997 decision and issued a supplemental decision in May 1998. However, the STB still concluded that BN's rates were reasonable.

Responding to McCarty Farms' challenges, the U.S. Court of Appeals agreed that it did not have jurisdiction over the category of claims regarding single-car wheat shipment for the two-year period ending September 12, 1980. The parties agreed with the Court's earlier ruling that it had jurisdiction over claims relating to multiple-car shipments of wheat and barley. Despite McCarty Farms' challenge that the Court of Appeals did not have jurisdiction over a third category of claims, single-car shipments of barley, and of wheat, after September 12, 1980, the Court held that it had jurisdiction. With respect to the claims over which it asserted jurisdiction, the U.S. Court of Appeals in October 1998 affirmed the decision of the STB.

### **Infrastructure Changes**

The extent and nature of rail service provided depends largely on the requirements of shippers. Consolidation in the agriculture industry has contributed to Montana's dependence on BNSF-owned and operated rail lines. Grain companies have built large rail loading facilities on Montana's major rail lines in an effort to reduce costs, and railroads are motivated to abandon light-density branch lines which generate relatively few carloads and small revenues.

This is part of a rationalization of railroad infrastructure which has occurred nationwide especially since Staggers. While some branch line operations cease to be profitable,

opportunities may yet exist to preserve them and/or to develop additional freight business. Some branch lines, such as those exclusively serving one customer such as a mine may have little reason to exist once the mine has been closed. On the other hand, mines sometimes re-open in a changing economy in response to factors such as increased ore prices.

### Grain Shuttle Facilities

Montana's rail system and transportation rates have been impacted by the construction of 110-car grain shuttle loading facilities throughout Montana's grain-growing regions.

As noted by the 1979 Montana Rail Plan, although the 110-car shuttle loading facilities are relatively new to Montana, the concept of centrally located grain terminals is not new.

The chief virtue of the grain subterminal concept is that it introduces major economies of scale which would be reflected in better utilization of the car fleet (probably dedicated equipment) and more reliable service (use of unit trains) eliminating the local service and switching operations presently taking place (enroute). It is a concept which is not now in existence anywhere in Montana, although it is quite common in the Midwest. Its practicality rests on (1) being able to pass along significant economic benefits (transport cost savings) to the farmers, grain elevator operators and railroads, (2) a willingness on the part of grain warehouses to combine together their shipping requirements into unit train quantities bound for a single destination, while retaining their independence and competitiveness in all other areas, and (3) the availability of capital funds to construct a strategically located grain subterminal and make necessary improvements to the highway system to sustain the "collector" trucking required in support of the terminal. This concept is the only long-term, technologically advanced solution possible today.<sup>12</sup>

Although the 1979 Rail Plan focused on the 26 and 52-car unit trains and facilities that were the industry standard at the time, the conclusions and recommendations also apply to the eleven new 110-car grain shuttle loading facilities that BNSF and the grain companies have recently constructed in Montana for the benefit of one railroad, BNSF. Although these facilities offer lower shipping costs and more efficiently use grain cars, they have also decreased business at smaller elevators, endangered several branch lines, and forced producers to haul their grain longer distances by truck on Montana's highways at a time of increasing fuel costs. Attachment 2 shows and locations and areas of influence of Montana's 110-car grain shuttle loading facilities.

The threat to Montana's branch lines is evident in BNSF's recent successful effort to abandon the Glendive to Circle Line and lease the Bainville to Scobey Line to a short line operator. Other grain-dependent lines such as the Great Falls to Fort Benton Line and the Havre to Big Sandy Line, which are both within the service areas of new 110-car shuttle loading facilities, are also at risk of abandonment as traffic declines and the physical condition of the lines deteriorates.

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<sup>12</sup> *Montana Rail Plan 1979*, pages 65-66

### Intermodal Facilities

In addition to the challenges faced by shippers of Montana's raw commodities such as grain and coal, Montana's value added businesses also face rail transportation challenges. These challenges increased when BNSF Railway closed its intermodal facility in Shelby in early 2005. This closure, which was especially harmful to efforts to increase trade with Canadian businesses, left Billings as the only intermodal facility on the BNSF Railway in Montana.

In addition, although the Port of Montana at Silver Bow has intermodal capabilities, and the Port receives numerous requests for this service, UP Railroad does not provide the cars and rates necessary to provide this service.

Access to intermodal rail service is an important factor in Montana's efforts to diversify and expand its economy. The decreasing availability of this access is problematic for these efforts.

### Geography

Geographically speaking, Montana's position on the national rail network is primarily as a bridge between major origination and destination points. Investment in and maintenance of rail infrastructure depends on the availability of traffic and revenue to support it. Montana's geographical distances and relatively low population density and railroad traffic origins and destinations make the state, in one sense, dependent upon bridge traffic to assist in supporting the railroad infrastructure that crosses the state.

### Montana's Class I Railroads Today

As a result of the above mergers and economic and regulatory actions and conditions, BNSF Railway is now the dominant Class I railroad in Montana. With its associated carrier MRL, BNSF accounted for over 98 percent of the origins and terminations of total state rail tons in 2002.

BNSF is not the only Class I railroad that serves Montana, however. Union Pacific (UP) Railroad serves the Port of Montana at Silver Bow in southwestern Montana and the Canadian Pacific (CP) Railway, through its lessee the Dakota, Missouri Valley, & Western Railroad, serves grain elevators at Westby and Whitetail in northeastern Montana. Although the traffic volumes on these two branch lines are minor compared to those on BNSF, the lines provide a critically important alternative to BNSF especially for agricultural shippers. For example, the Scouler Grain facility at the Port of Montana attracts grain from Montana's Golden Triangle and Eastern Montana via Montana's Interstate Highways. The State of Montana has invested nearly \$2 million in Local Rail Freight Assistance Program funds in these two lines in the last twenty years due to their importance to Montana shippers.

## **Summary**

In summary, Montana's "captive state" status is the result of a combination of railroad mergers, consolidations, and bankruptcies; Federal regulatory changes (Staggers); infrastructure changes; and Montana's geographic position.

Staggers improved the ability of railroads to operate their businesses. Because railroads were given considerable marketplace latitude, the availability of competition at any particular location became very important to railroad customers. In the case of low-value high-bulk commodities such as grain and coal, rail and barge are the only economic methods of transport over significant distances. It is axiomatic that demand for rail service affects competition. Montana, half way between major railroad markets, has suffered from this geographic disability. In a deregulated market, railroads have been able to lower their costs while transporting greater amounts (e.g., 110-car shuttle trains), while having fewer constraints on their ability to abandon non-productive rail lines.

## **Potential Solutions**

The 2004 *Senate Bill 315 Rail Freight Competition Study*<sup>13</sup> presented a number of potential solutions to Montana's current situation related to railroad competition. Following is a summary of some of these and other solutions:

### **1. Rate Adjudication**

The jurisdictional thresholds for STB maximum rate authority is a showing that rates exceed 180 percent of variable cost and that there are no reasonable alternative transportation services available (i.e., that the affected shipper is "captive" to the serving railroad.)

STB authority over maximum rates is limited to non-contract movements. The jurisdictional revenue to variable cost threshold and a showing of the lack of reasonable transportation alternatives should be achievable on many Montana-originated movements but usefulness of this remedy is questionable on two counts: first, litigation using complex stand-alone cost (SAC) formula would be very costly (probably in excess of \$4 million per proceeding), lengthy, and with uncertain results.<sup>14</sup> Abbreviated review methodology, using "Revenue Shortfall Markup Allocation" would produce, for BNSF (using 2002 data) mandated rates equal to a 2.73 revenue to variable cost ratio – the amount calculated by the STB needed for BNSF to be "made whole" on average, for all of its "captive" traffic – i.e., that now generating revenue in excess of 180 percent of variable costs. This ratio is slightly above BNSF's current tariff rates for Montana grain.

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<sup>13</sup> *Senate Bill 315 Rail Freight Competition Study*, prepared by RL Banks & Associates for the Governor's Office of Economic Opportunity, 2004

<sup>14</sup> A recent informal survey of recent-year rate cases indicates that the railroads win more than they lose; odds based on this survey are about 2:1 in favor of the railroads.

2. Terminal Access Provision

The STB can order a railroad to permit another railroad to use its facilities. The sole non-merger related legal authority for imposed access is the Terminal Access provision of the Interstate Commerce Act. Statutory requirements for grant of access to a second carrier include “practicability,” whether it would comport with the public interest, and whether it can be achieved without substantively interfering with the resident carrier’s operations. The law is now rarely successfully invoked. As interpreted by the STB, applicants wishing to invoke the provision must also show anti-competitive conduct on the part of the host carrier - e.g. standard antitrust violations such as refusal to deal, predatory pricing, foreclosure of competition, etc. Generally, the STB has been strongly disinclined to impinge on any railroad’s property rights under any circumstance. It is therefore unlikely the STB would approve such a remedy and it is also uncertain whether this would guarantee lower-rates. It is also questionable whether another railroad would be willing to incur the significant costs of pursuing this option.

3. Expanded Compelled Access

Canada has enacted legislation which conveys the right, upon petition, for shippers to employ compliant competitive carriers access over up to 500 miles of a directly serving railroad’s line under the rubric of “Competitive Line Rates” or “CLRs,” Canadian legislation has also expanded the geographical scope of compulsory interswitching districts, within which railroads must handle each other’s traffic if necessary and efficacious. There are several potential forms of open-access regulations which have been developed and which may ultimately prove economically sound.

CLRs have generally failed to achieve their intended outcome because cost savings have been limited, given the operational inefficiency inherent in dispatching individual trains, likely of sub-optimal length, through unfriendly railroad territory, and because of a “live and let live” ethic commonly found in duopolistic settings. The non-resident railroad is less likely to respond to shippers’ entreaties if it wishes to avoid the reciprocal incursion of its competitor on its own tracks.

Railroads on occasion provide access to their lines to non-competing entities such as shippers. Rarely used in instances where carriers have market power, and also more common when traffic is routed over multiple systems, shipper-owned trains may be moved under “hook and haul” arrangements. Shippers are responsible for the provision of rolling stock and providing an assembled train to be pulled by railroad-owned and operated motive power. Although the availability of shipper-owned equipment may improve equipment availability, and BNSF already provides equipment guarantees to shippers which do contribute equipment to the grain fleet, mandatory “hook-and-haul” service poses many hurdles, both legal and operational, to be of much prospective benefit to Montana’s shippers.

#### 4. Rate Arbitration

Rate arbitration, as enacted in Canada and proposed in the Rail Competition Act (S 919, HR 2924) offers potential relief to shippers. Among railroad objections to arbitration is its inherent imbalance – the existing rail tariff is a cap to potential arbitrated rates, and therefore a shipper has nothing to lose and a railroad nothing to gain by entering into enforced arbitration. Equally fundamentally, there is no generally accepted standard by which to determine whether or not a rate is “reasonable,” thus leading to either a patchwork of random outcomes or, over time, to the use of settled formulas for resolving rate disputes. Although time-testing of arbitration may establish a customary range of rates, they would still be arbitrary and could still result in the institutionalization of a costly and bureaucratic process overlaid on what should otherwise be a straightforward commercial negotiation.

#### 5. Antitrust Immunity

Railroads retain partial immunity from US antitrust laws. However, some believe that termination of this immunity is the answer to Montana’s rail issues.

Among immunities granted by statute are 49 U.S.C. §1132(a), which provides for rail carrier exemption for all actions necessary to carry out a consolidation approved by the STB; 15 U.S.C. §26, which denies injunctive relief under the antitrust laws to plaintiffs in litigation opposing railroads; and 49 U.S.C. §10501, which gives the STB exclusive jurisdiction over rail transportation matters and renders ambiguous the applicability to railroads of many other laws. Further, judicial decisions have expanded the scope of railroad freedom from antitrust restraints, such as *Keogh v. Chicago and N.W. Ry. Co.*, 260 U.S. 156 (1922), which barred treble damage actions arising from injury incurred because of rail tariffs filed with the ICC.

Rail mergers have concentrated market power markedly. In Montana a single railroad retains a market share of over 90 percent. There has been no competition-enhancing change in rail transportation policy to correspond with this increased industry concentration, despite the avowed intent of the Staggers Act to leave rates subject to competitive forces.

It appears to have been the intent of Congress to moderate the effects of these immunities, at least with respect to railroad consolidations, by allowing the enforcers of the antitrust laws to have a voice. The ICC Termination Act of 1995 instructed the STB, in making findings with respect to the competitive aspects of proposed mergers, to “accord substantial weight to any recommendation of the Attorney General [i.e., Department of Justice (DOJ)]” (49 USC § 11324).<sup>15</sup> In the Union Pacific-Southern Pacific merger case, DOJ argued that the anticompetitive effects of the proposed merger were so great as to require that the application be denied. The STB devoted one third of a page of its 290-page decision to denial of all DOJ requests. The STB characterized one of DOJ’s concerns as “remarkable” and concluded its discussion

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<sup>15</sup> However, DOJ can only challenge an STB merger decision on the grounds that a material error was made; and not on the basis of antitrust principles.

with the words: “We strongly disagree.”<sup>16</sup> Such strong admonishments were reserved for a very select minority of interveners.

In December 1999, under pressure from several parties including competing railroads, a proposed consolidation of CN and BNSF sparked reconsideration of merger guidelines applicable to transactions in the United States. The guidelines proposed by the STB involve an extensive expansion of filing requirements and an unprecedented depth of inquiry, all with the intended effect of slowing or halting industry restructuring. Virtually all of the rules eventually promulgated are highly industry-specific. Unlike in Canada, where railroads are subject to the same competition laws as are other industries, the new STB rules have few analogs with the criteria, generally applicable to the rest of the economy, that the U.S. Department of Justice and the Federal Trade Commission apply in their examination of mergers. (See STB Ex Parte No. 582 (Sub-No. 1) Major Rail Consolidation Procedures October 3, 2000; Notice of Proposed Rulemaking.)

Expanding antitrust principles to rail carriers may limit opportunities for future abuses of railroad power, but the effectiveness of termination of antitrust immunity in resolving today's captive shipper problems, given the *fait accompli* conditions facing Montana shippers and the reluctance to break up existing corporations, is questionable at best.

6. Promote Class I Competition

This is of major importance to Montana, and the State has enjoyed a degree of cooperation from other Class I railroads. CP contributed its own money to recent upgrades to the DMVW Westby-Whitetail rail line in Northeastern Montana, and the State of Montana has provided over \$800,000 in Federal Local Rail Freight Assistance grants to improve this important line over the last five years. UP has been helpful in enhancing competitive rail service at the Port of Montana at Butte. The State of Montana used a federal Local Rail Freight Assistance loan to help construct a grain terminal at Silver Bow over 20 years ago. This facility is operated by Scoular Grain, which uses UP to transport Montana grain to Pacific Northwest ports. This competition has reportedly caused BNSF to maintain lower rates, and even offer incentives, to shippers. This demonstrates that, where there is competition, Montana shippers see BNSF rates drop.

The opportunity for significant change in this area is limited by (1) feasibility with regard to the geographic extent to which competitive Class I railroads can enter into Montana and (2) the ability of those railroads, especially at this time when all Class I railroads are at or near capacity, to provide additional service. Nevertheless, these are competitive options which deserve consideration and reinforcement.

7. Re-evaluate State Railroad Taxation Practices

Despite the enactment in 1976 of Federal law which prohibits discrimination against railroads in property taxation, many states may inadvertently be discriminating in

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<sup>16</sup> STB Decision No. 44, Decided August 6, 1996, p.198.



favor of railroads by undervaluing their taxable assets, particularly those with which carriers have been able to collect monopoly rents such as grain lines and rail equipment employed in areas in which no meaningful competition exists. Monopoly-based rates, after all, increase the value of rail properties while depressing the value of taxable properties which produce the goods transported by railroads.

Creative use of tax policy bears further exploration. Tax policy may be targeted to better capture the costs of highway damage occasioned by the shift to shuttle facilities and the abandonment of short lines, encourage the retention of local elevators as feeder facilities, and cause railroads to surrender a portion of excess profits garnered through excessive rates.

8. Recover Additional State and Local Costs

Each mile that a grain-carrying truck travels on Montana roads exacts an estimated cost of 26 cents in highway maintenance expense. (For a truck averaging five miles per gallon, the 27  $\frac{3}{4}$  cents per gallon special fuels tax captures only about five and one-half cents per miles, or about one-fifth of this cost.) A 10-million bushel through-put shuttle facility would, on average, have a draw area four times the size of a more conventional two and one-half million bushel elevator, and add an estimated 41 miles (68 miles versus 17 miles) to the average farm-to-elevator roundtrip.<sup>17</sup> The additional 41 miles equates to a burden imposed on localities and states of just over \$10.00, or one cent per bushel for a typical 1,000-bushel truckload. Two cost-recovery tax initiatives are:

(a) Impose a graduated tax on elevators based upon through-put. Given that the larger the through-put the larger the draw area, a 10-million bushel facility could be taxed one cent per bushel to compensate for additional road damage; a five-million bushel facility, which would generate average roundtrips of 34 miles, or 17 miles above the base, would be taxed at about four-tenths of a cent per bushel ( $17/41 \times$  one cent), and smaller facilities would be exempt. The tax could be applied either directly to the elevator or to the loading railroad to reduce complexities in calculating tax rates applicable to multiple-facility rail locations.

The effect of the tax would be to encourage the more efficient allocation of resources by more specifically assigning responsibility for costs to the cause of those costs. It is immaterial whether the tax is assessed directly against the railroad or the elevator. If assessed against the elevator, and if the railroad with monopoly power is in fact exercising a profit-maximization strategy, then, in theory, the railroad would absorb most of the tax by lowering rates accordingly, as failure to do so would reduce incentives to develop shuttle-capable facilities.

Exemptions from the per-bushel tax may be applied to the extent that a large elevator employs a pre-existing local elevator as a feeder facility. If the feeder facility is located on a branch line which maintains rail service, an additional

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<sup>17</sup> These estimates assume, for purposes of simplicity, non-competing and non-overlapping draw areas. Given the reality of overlapping draw areas the actual draw areas may be relatively larger.

credit may be considered. A highway-damage-avoidance credit in conjunction with BNSF affording co-loading privileges to a short line operator may be packaged (to mutual benefit) to maintain the economic viability of otherwise threatened facilities, such as the elevator at Big Sandy.

(b) Apply the special fuels tax to railroads, with an exemption accorded to the proportion of revenue ton miles which pertain to rail movements, such as coal, which do not require feeder service via highway. Railroad policies encouraging larger elevators or abandoning branches have a direct impact on the use of public highways. Railroads should accept a portion of the responsibility for their profit-oriented policies by paying a portion of the public costs.

#### 9. Adjust Tax Rates

The profitability of railroad assets located in Montana is substantively enhanced by railroad rates being made without need for due consideration of competitive alternatives. Montana's property tax and corporate tax systems do not appear to take this fact into account. Railroad ability to recover higher state taxes from shippers will be constrained to the extent that the railroads are already charging, "what the market will bear." Possible modifications of tax policy (which may be negotiated in exchange for railroad rate and service concessions) include:

(a) Assessment of income attributable to state operations.

The 6  $\frac{3}{4}$  percent state corporate income tax is calculated based upon a variety of factors which may understate the excess of revenue over variable and allocated fixed costs earned by in-state operations. Virtually all of BNSF's system-wide earnings above variable cost are generated by the fraction of traffic which is charged above the STB's jurisdictional threshold of 180 percent of revenue to variable cost. Net income attributable to Montana shippers must therefore be well above the fraction of gross income, or car miles, that is allocable to the state.

(b) Assessment of property taxes. Property tax assessments pertaining to railroads have been contorted over the past 28 years by Federal legislation prohibiting anti-railroad tax discrimination.<sup>18</sup> This legislation has generated a large volume of litigation and a resolution of the Multistate Tax Commission seeking to undo the damage the Federal law has caused. Currently, following a formula intended to comply with the 4-R Act, Montana railroad property is taxed based upon 3.88 percent of market value, which is the calculated average percentage applicable to

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<sup>18</sup> Section 306 of the Railroad Revitalization and Regulatory Reform Act of 1976, 49 U.S.C. 11501 (4-R Act) protects railroads from discriminatory tax assessments. Section 306(b)(1) of the Act provides in relevant part that "a State" or "authority acting for a State" may not "[a]ssess rail transportation property at a value that has a higher ratio to the true market value of the rail transportation property than the ratio that the assessed value of other commercial and industrial property in the same assessment jurisdiction has to the true market value of the other commercial and industrial property." 49 U.S.C. 11501(b)(1). Relief may be granted "only if the ratio of assessed value to true market value of rail transportation property exceeds by at least 5 percent the ratio of assessed value to true market value of other commercial and industrial property in the same assessment jurisdiction." 49 U.S.C. 11501(c).

all Montana commercial property.<sup>19</sup> Clearly, under the law, the tax base can be increased by at least five percent, to 4.07 percent. However, an analysis could be undertaken to determine whether the state-average tax percentage is in fact the appropriate base under 4-R act strictures. Under the State's property tax classification system, the most comparable classes of property are those pertaining to other network industries – all of which have taxable value percentages of from 6 to 12 percent. Pipeline and electric distribution properties in particular (class 9) are assessed at the highest rate.<sup>20</sup> It is arguable that it is not discriminatory to tax railroads at the same rate as other comparable businesses.

**If a new tax policy is devised, it is very important to avoid any action which could allow the entity being taxed to “transfer” the tax burden to the grain producer.**

Also, it seems appropriate to direct the revenue resulting from any such tax not to the general fund, but to where it will do the most good in mitigating adverse effects of the current situation. For example, the revenue could be directed to assist non-shuttle-train movers of grain, or to repair highway damage.

#### 10. Multi-State Cooperation

Two or more states working together are more potent politically than one state working alone. Other grain-producing states, to perhaps a lesser extent, have service and price issues with the Class I railroads. The Western Governors' Association is also a forum that has addressed railroad issues.

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<sup>19</sup> Montana Code Annotated, 15-6-145. Class twelve property -- description -- taxable percentage. (1) Class twelve property includes all property of a railroad car company as defined in 15-23-211, all railroad transportation property as described in the Railroad Revitalization and Regulatory Reform Act of 1976 as it read on January 1, 1986, and all airline transportation property as described in the Tax Equity and Fiscal Responsibility Act of 1982 as it read on January 1, 1986.

(2) For the tax year beginning January 1, 1991, and for each tax year thereafter, class twelve property is taxed at the percentage rate "R", to be determined by the department as provided in subsection (3), or 12%, whichever is less. [CURRENT RATE = 3.88%]

(3)  $R = A/B$  where:

(a) A is the total statewide taxable value of all commercial property, except class twelve property, as commercial property is described in 15-1-101(1)(d); and

(b) B is the total statewide market value of all commercial property, except class twelve property, as commercial property is described in 15-1-101(1)(d).

<sup>20</sup> Classes of Property

The property classification system is as follows (Tax Year 2004 taxable value percentages are in parenthesis)

Class 7      Qualifying rural electric associations (8%)

Class 9      Real & personal property of pipelines and the non-electric generating properties of electric utilities (12%)

Class 12     Real and personal property of railroads, railroad car companies, and airlines recalculated each year (3.88% for tax year 2003)

Class 13     Real & personal property of telecommunication utilities and the electric generating property of electric utilities (6%)

Source: Montana Department of Revenue

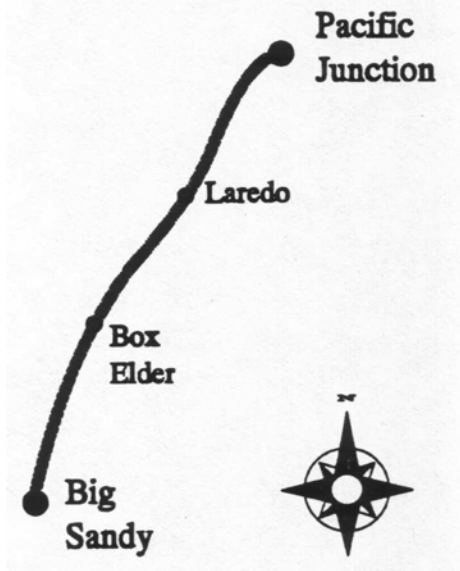
11. Assist Montana Shippers

Montana could develop means to assist Montanans impacted by high rates and poor service. This might include assistance in transporting goods by highway to existing points of competition: Butte, Sweet Grass and Whitetail-Westby, as well as barge loading facilities in Idaho.

12. Support Federal Legislation

Since the long term solution to the competition problem is at the Federal level, Montana and its Delegation could support Federal Legislation such as the Rail Competition Act of 2005 (S 919) and the Railroad Competition, Improvement and Reauthorization Act of 2005 (HR 2047). These two acts attempt to address rail competition problems by removing bottleneck limitations, eliminating paper barriers, expanding interchange switching, and clarifying national rail policy to ensure the STB is more diligent in 1) ensuring competition among rail carriers, 2) maintaining reasonable rates in the absence of competition, and 3) maintaining consistent and efficient rail transportation service for rail shippers, including timely provision of rail cars.

**EXHIBIT 4-30  
BIG SANDY SUBDIVISION**



## Havre – Big Sandy Branchline

Track Length	Rail Weight	Carloads*	Primary Commodity	Track Speed
31.2mi	110lbs.	282	Wheat & Barley	10 mph

\* 2003 Data

The Havre – Big Sandy line has a maximum track speed of 10 mph and can carry 268,000-pound cars. Traffic on the line in 1991 was 1,747 carloads of primarily wheat and barley compared to essentially no carloads per year now. The grain elevators on this line are:

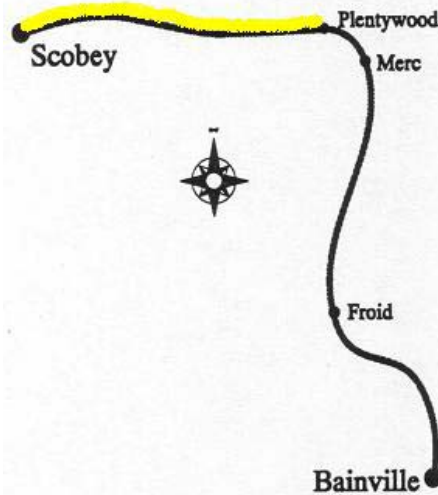
- Havre
  - Cenex Harvest States – Capacity - 110 Car, 511,000 bushels (West Unit)
  - Cenex Harvest States – Capacity – 110 Car, 240,000 bushels (East Unit)
  - Columbia Grain – Capacity – 54 Car, 450,000 bushels
- Big Sandy
  - Cenex Harvest States – Capacity – 54 Car, 290,000 bushels

The most important issue threatening the future of this line is the impact of the Cenex Harvest States (CHS) 110-car shuttle facility in Havre, 31 miles to the north, which offers lower transportation rates than those available for the Big Sandy elevator. Since CHS also owns the Big Sandy elevator, the grain it used to load at the Big Sandy elevator is now moving by truck to the CHS 110-car shuttle facility in Havre to take advantage of the better rates.

If this situation continues, BNSF Railway will probably pursue the Class Exemption Process with the Surface Transportation Board which would allow it to abandon this line as it did with the Glendive to Circle line in Eastern Montana<sup>1</sup>. It is unlikely that CHS would oppose this request.

<sup>1</sup> Rail lines that have not had any rail traffic in two years are eligible for the Class Exemption Process which allows railroads to avoid most of the normal Federal abandonment requirements. The process can result in STB approval of the abandonment less than sixty days after the initial request.

**EXHIBIT 4-28  
SCOBEEY SUBDIVISION**



## Plentywood – Scobey Branchline

Track Length	Rail Weight	Carloads*	Primary Commodity	Track Speed
43.63mi	77lbs.	303	Outbound Wheat	10 mph

\*Last year of service was 2002

The Plentywood – Scobey line is Federal Railroad Administration Class 2 track with a maximum track speed of 10 mph. The line can carry 268,000-pound cars. BNSF ceased operations on this line in 2002. Traffic on the line was virtually all outbound wheat before then. Traffic in 1999 was 679 carloads originating at Scobey. Because of the weight of the rail, the line cannot safely accommodate the 286,000-pound current interline standard. The grain elevators served by this line are:

- Scobey
  - Farmers Elevator – Capacity - 54 Car, 500,000 bushels
- Plentywood
  - Columbia Grain – Capacity – 52 Car, 409,000 bushels

In late 2003, BNSF notified Montana it planned to initiate the Class Exemption Process<sup>1</sup> with the Surface Transportation Board (STB) in order to abandon this line. After the State expressed concern about this action and requested a delay to allow State and local officials to explore options to maintain service, BNSF Railway agreed to postpone its formal filing until after June 30, 2004. The *Montana Branch Line Study-Phase I*, which examined service preservation options in cooperation with shippers and local officials, also confirmed that BNSF Railway was offering incentives to area producers to truck their grain to the 110-car shuttle facility at Macon east of Wolf Point. Following completion of the study, BNSF Railway decided to lease the Bainville to Scobey Line to a short line operator and Yellowstone Valley Railroad (YSVR), a subsidiary of Watco Companies, began operating the line through a fifteen-year lease in August, 2005.

Note: BN previously abandoned the western extension of this line from Scobey to Opheim using the regular Interstate Commerce Commission (ICC) abandonment process. Shippers and State and local government officials strongly opposed the abandonment including providing testimony at a field hearing in Opheim in May, 1990. However, the ICC ultimately approved the abandonment effective July, 1992.

<sup>1</sup> Rail lines that have not had any rail traffic in two years are eligible for the Class Exemption Process which allows railroads to avoid most of the normal Federal abandonment requirements. The process can result in STB approval of the abandonment less than sixty days after the initial request